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Tax Expenditure Evaluation Best Practices

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Agenda

- Why evaluate tax incentives?
- National context for evaluation
- Evaluation best practices
- Colorado's tax expenditure evaluations
- How states have used evaluations to inform policy decisions

Why evaluate tax incentives?

Why evaluate tax incentives?

- One of states' primary economic development tools
- Collectively cost states billions of dollars per year
- Evaluation is a proven way to improve the effectiveness of tax incentives

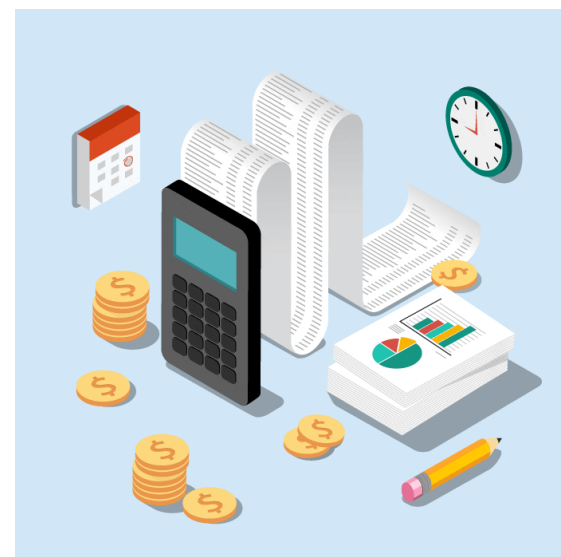


Image source: <https://www.debt.org/tax>

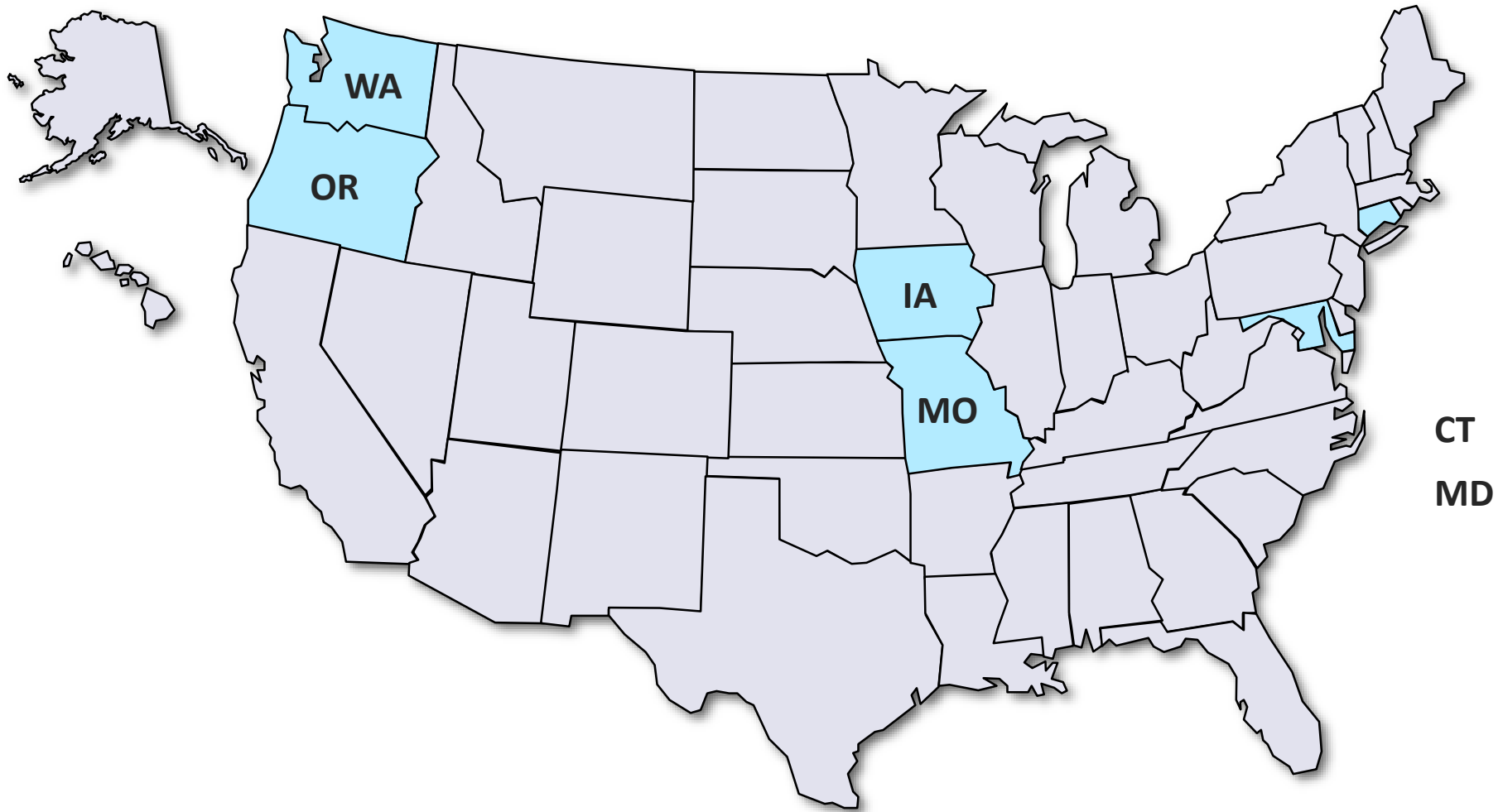
With evaluations, states can...



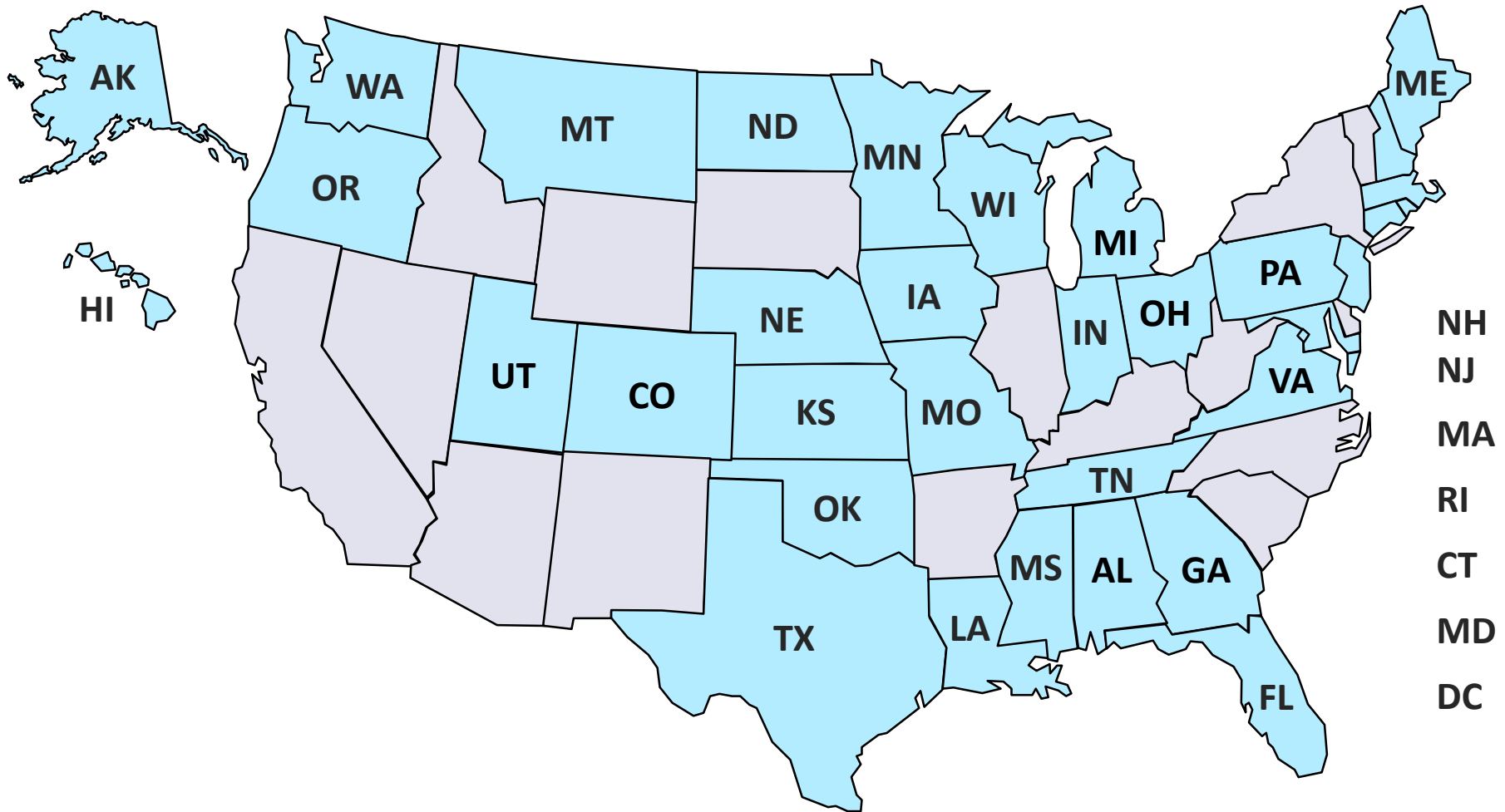
- Identify programs that are working well, so that the state can invest in them with confidence
- Make subtle changes to incentives to increase their return on investment
- Repeal or replace ineffective or obsolete incentives
- Analyze whether incentives are serving the needs of beneficiaries
- Have a more constructive conversation about incentives

Evaluation in the States

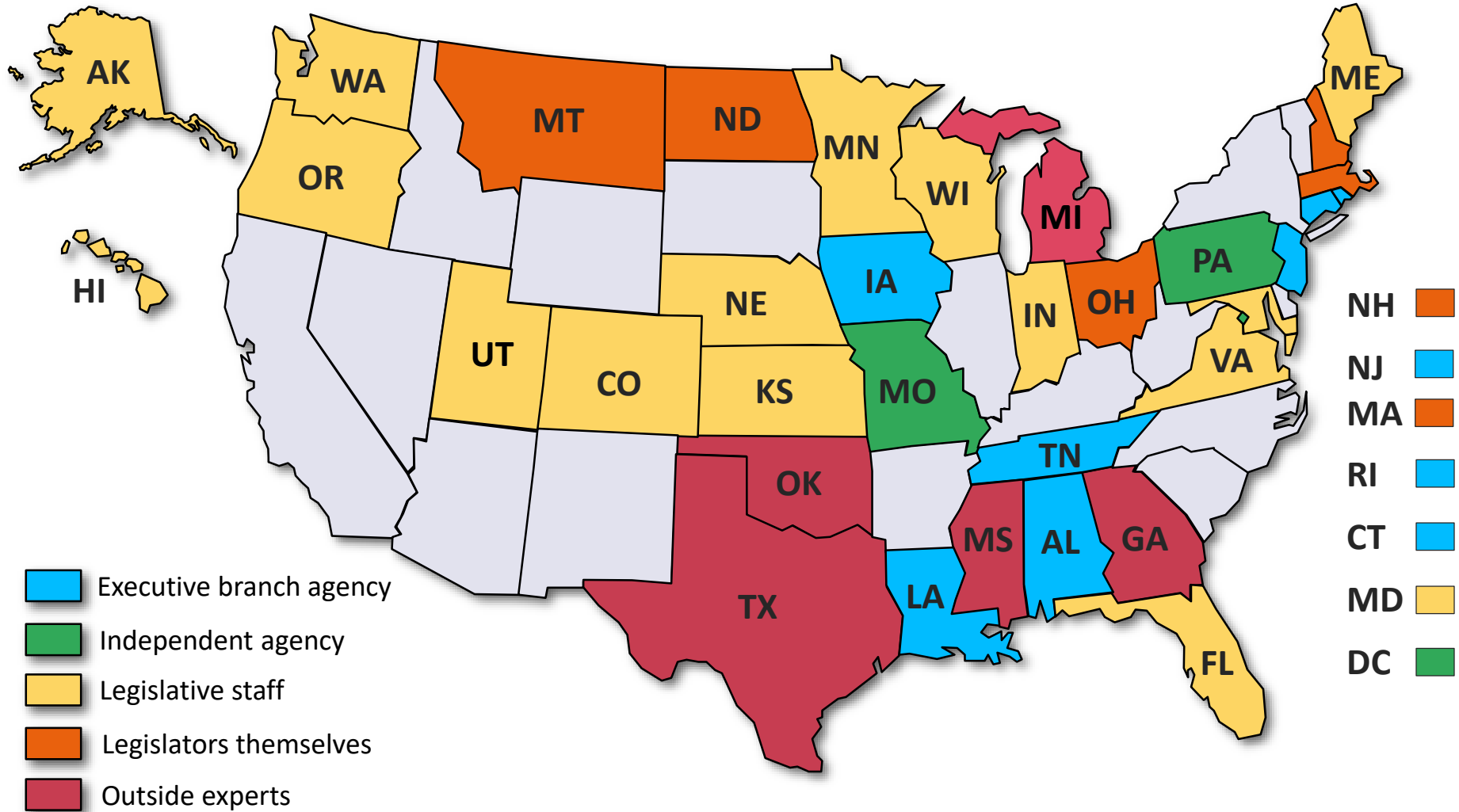
The Changing Landscape of Incentive Evaluation – Pre-2013



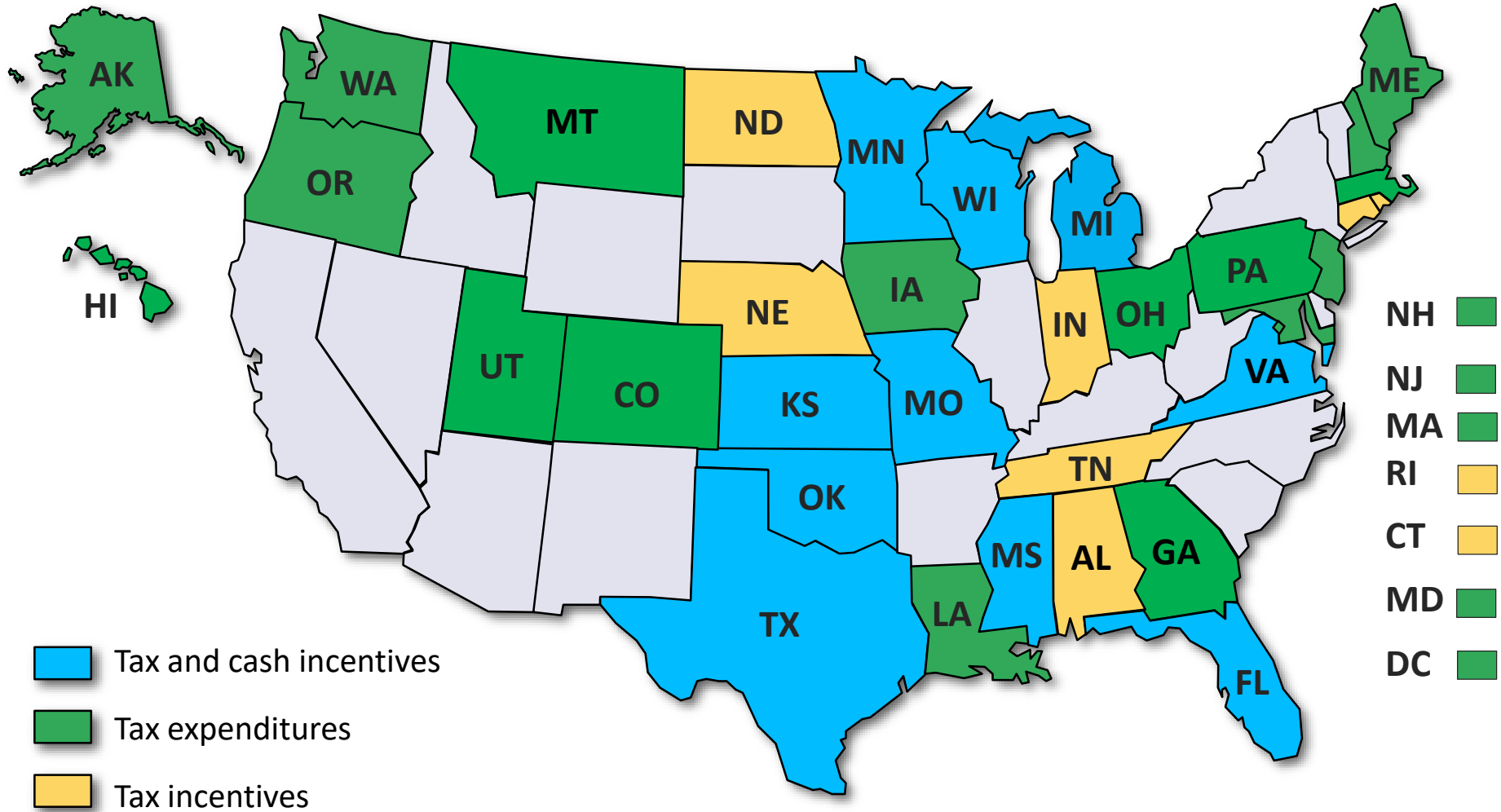
The Changing Landscape of Incentive Evaluation – 2021



State Evaluation Offices



Scope of Evaluations



Components of High-Quality Evaluations

At minimum, evaluations should include...



- A description of the incentive, including its history and goals
- An assessment of the program's design and administration
- Estimates of the expenditure's economic and fiscal impacts
- Policy recommendations

Other criteria to consider



- **Displacement** – to what extent does the expenditure benefit certain taxpayers at the expense of others?
- **Leakage** – does the expenditure benefit non-state residents?
- **Timing** – how does timing impact the level of fiscal risk and economic return to the state?
- **Opportunity costs** – are there trade-offs related to expenditure costs?
- **“But-for”** – does the credit change taxpayer behavior?

What is the “but-for” question?



- To what extent does an incentive influence business decisions?
- Does the incentive reward businesses for activity that would have occurred anyway?
- Activity rarely is 100% attributable to incentive
 - Ranges from 0% - 100%
- Can be reasonably estimated

Concepts to consider



- Tax elasticity
 - How do businesses respond to changes in tax rate?
- Price elasticity
 - How much additional activity is generated as a result of cost reductions?
- Sensitivity analysis
 - How do results vary when comparing how effective scenarios are at changing behavior?

Concepts to consider



- Break-even analysis
 - How much activity would need to be attributable to the incentive for it to be a superior option?
- Gap analysis
 - Would the project have proceeded absent state funding?
- Business surveys

Colorado's Tax Expenditure Evaluations

Colorado's Evaluation Legislation



- 2015 HB 1205
 - Did not pass
- 2016 SB 203
 - Passed unanimously by Colorado General Assembly; signed into law on June 6, 2016

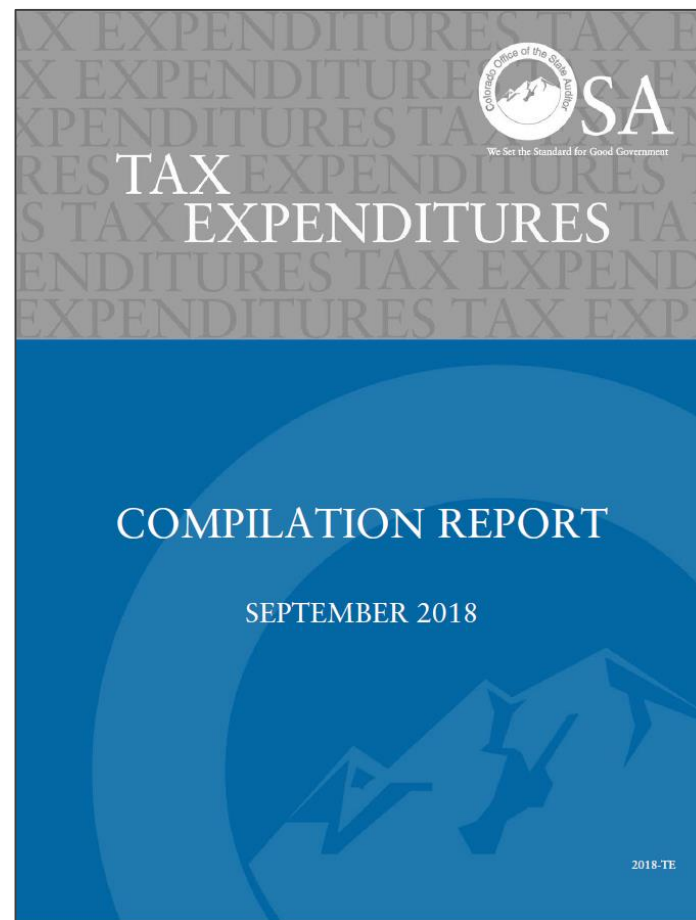


Colorado's Evaluation Process

- Office of the State Auditor (OSA)
- Evaluation scope and schedule:
 - Five-year schedule, starting with the oldest tax expenditures
 - Timely review of sunseting tax expenditures
 - New expenditures automatically subject to review
 - OSA may revise the schedule
- Reports submitted to the General Assembly, the Joint Budget Committee, and finance committees of each chamber
- New oversight—Legislative Oversight Committee Concerning Tax Policy

OSA Tax Expenditure Reports

- OSA released its first evaluation in September 2018
 - Analyzed 15 tax expenditures
- According to OSA's evaluation schedule (Aug 2021), 162 expenditures have been evaluated



Evaluation-based policy change



- 2019 Tax Expenditure Evaluation Interim Study Committee
 - Referred five bills; requested Statutory Revision Committee to consider repealing additional expenditures identified as obsolete or unused.
- 2020 Legislative session – enacted changes
 - Established requirements for newly created tax expenditures
 - Clarified long-term lodging sales tax exemption eligibility requirements
 - Modified net operating loss deduction
 - Repealed three expenditures:
 - » Residents of bordering states sales tax exemption
 - » Nonprofit transit authority agency fuel tax
 - » Pre-1987 net operating loss deduction

Other State Examples: Using Evaluation Conclusions to Inform Policy Decisions

Models for connecting evaluations to policymakers



- **North Dakota:** Legislators as evaluators
- **Rhode Island:** Gubernatorial recommendations
- **Oklahoma:** A commission that includes executive branch officials
- **Numerous states:** Designate a specific legislative committee to hold hearings on evaluations

Questions legislators may consider:

- Is the program designed to achieve its intended goals?
- Does the program duplicate another in the state?
- Are those eligible for the program aware it exists?
- Are there programs offered in other states (at what level)?
- What are the consequences if the program is modified?
- Is the program's purpose still relevant and is the cost justified?
- Are program eligibility requirements appropriately defined?
- Is the program administered efficiently?



Evaluation success stories

- Maryland Job Creation Tax Credit
- North Dakota Angel Investment Tax Credit and 21st Century Manufacturing Workforce Incentive





Maryland



Job Creation Tax Credit

- 2016 Department of Legislative Services evaluation found certain design and administration features were limiting effectiveness
- In 2017, the General Assembly implemented five recommendations from the report



North Dakota



Angel Investment Tax Credit

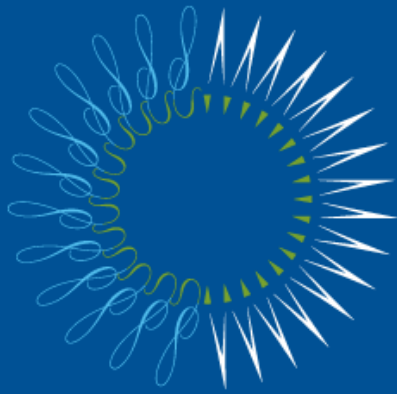
- Evaluation identified a flaw in program design: credits awarded to companies located outside of the state
- Reformed program improves targeting of credits to businesses located in ND

21st Century Manufacturing Workforce Incentive

- Evaluation identified a gap in the state's economic development programs
- Recommended creating an incentive to assist businesses in modernizing their manufacturing processes
- New incentive created in 2019

Conclusion

- Evaluating tax incentives is increasingly common
- Evaluations have led to policy changes that are designed to help programs better meet their goals and stem revenue losses
- Colorado's tax expenditure evaluation process reflects best practices for states



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Questions?

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